Financial Markets

Irving Trust

Irving Trust Company
One Wall Street
New York, NY 10015

Economic Research &
Planning Division

Friday
(Noon)

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One small slice of humble pie, please. Yes, I am fully aware that in my last letter (July 15) I stated that the Fed would not change its M1 target at its mid-year target review. However, I argued (and still maintain) that changing that target was not worth the risk. It would not be advisable now for the Fed to hit the new M1 target "no matter what." Still, it will impair the Fed's credibility to miss yet another M1 target. Indeed, the markets have lost a lot of ground since this change in the M1 target was announced. I think the market is not reassured by what the Fed did. Let's look at the new policy environment.

First, the Fed has downgraded M1 formally to an aggregate with a monitoring zone, not a target zone; M1 has the same status as the experimental credit aggregate--hard to believe. Also, the Fed admits to becoming slightly less accommodating in its policy; the first steps occurred in a split vote at the May 24 FOMC meeting shortly after M1 had risen $7.1 billion in one week (May 11). This policy move evidently was prompted by M1's rising against the background of a strong economy. Clearly M1 has been an important element in the Fed's policy response, and that remains true even with the formal downgrading of the aggregate's status. After all, if M1 were irrelevant would the Fed have bothered to set a new target range for it?

The Fed had laid the groundwork for missing its original M1 target this year by saying that M1's desired performance depended on the performance of M1's velocity. Instead, the Fed abolished that target, made a fairly explicit bet on velocity, and set a new target. If the economy expands at just a 10% nominal rate in the second half of 1983, a 1% velocity increase will be needed if the new M1 target of 9% maximum growth is to be reached; stronger GNP growth requires a larger increase in velocity. Velocity did increase in the second quarter, but only marginally. So why would the Fed take such a chance?

This is the hard question to answer. Setting another target for M1, and one that might not be reached, does not help the Fed's public image. The continuing shift of the aggregate's base (from which growth is calculated) and change in the growth rate make the Fed's activities look more and more like those undertaken by the Fed under the leadership of Arthur Burns, when inflation was a problem. While Volcker is not Burns, neither will Volcker be around as long as was Burns. Thus whatever personal reassurance Mr. Volcker brings, it does not necessarily carry fully into the long end of the market and transcend the Fed as an institution.

Even the setting of tighter M2 and M3 targets next year does not satisfy. Look at how shabbily the M1 target has been treated this year! Moreover, some feel that M1 is so close to the new range that the Fed will have to pay attention to it. Thus market attention has come to be more riveted on M1, not less. And fear of the large budget deficits continues. In this environment, the Fed now has a monumental task even in articulating its policy. Yet nothing has really changed that much. M1 is playing a more schizophrenic role; M1's velocity is a central issue; while discretion and judgment reign supreme. Through all this, it is not clear what a consistent Fed policy would look like. This is one reason why the markets are so unsettled, and why I have ordered humble pie but will not eat it.

Robert A. Brusca

Irving Trust

Market Yields

	7/29/83 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	10.50%	10.50%	15.50%
Effective since	2/28/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	11.50
Federal Funds	9.50	9.38	11.25
Repurchase Agreements	9.13	9.20	9.25
U.S. Treasury Issues			
Bills			
3 months	9.50	9.41	10.68
6 months	9.97	9.81	11.93
1 year	10.35	10.15	12.49
Coupons			
2 years	10.91	10.73	13.44
4 years	11.37	11.13	13.65
7 years	11.62	11.33	13.80
10 years	11.66	11.36	13.68
Long Bond	11.68	11.40	13.40
Negotiable Certificates of Deposit-Secondary Market			
1 month	9.45	9.30	11.35
3 months	9.60	9.45	12.00
6 months	10.15	9.95	12.75
1 year	10.55	10.35	13.25
Banker's Acceptances			
1 month	9.40	9.32	11.30
3 months	9.70	9.57	11.95
6 months	10.17	9.92	12.90
Eurodollar Deposits			
1 month	9.75	9.63	12.19
2 months	10.00	9.81	12.56
3 months	10.13	9.94	13.00
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	9.40	9.14	10.67
1 month	9.45	9.33	11.51
3 months	9.74	9.60	11.88
Bank Holding Companies			
1 month	9.19	9.07	11.39
Dealer Placed:			
3 months	9.63	9.58	11.74
New AA Corporate Utility Bond	13.00	12.60	15.85
Tax Exempt			
6 month Project Notes	4.95	4.95	7.25
1 year AAA Bond	5.50	5.10	7.75
5 year AAA Bond	7.00	7.00	9.20
20 year AAA Bond	9.30	9.00	11.10

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

Cable Address:
"IrvingBank" Telex: I.T.T. 420268 • R.C.A. 232241
W.U.I. 62832 • French 82629

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